In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-965

WARNER COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion and order of the district court (Pet. App. C, A32-A74) are not reported. The opinion of the court of appeals (Pet. App. B, A6-A31) is reported at 504 F. 2d 689.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1974. A petition for rehearing *en banc* was filed on October 10, 1974, and denied on November 7, 1974. The petition for a writ of certiorari was filed on February 5, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in determining for purposes of the depletion allowance what portion of the income of petitioner, an integrated miner-manufacturer, was from mining, the court of appeals correctly held that a "representative market or field price" existed for petitioner's limestone so that the "proportionate profits" computation method was inapplicable.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 611 and 613, Internal Revenue Code of 1954, and of Section 1.613-4, Treasury Regulations on Income Tax (1954 Code), are set forth at Pet. 3-4, and at Pet. App. A, A1-A5.

STATEMENT

Petitioner is engaged in the mining and the processing of limestone into lime. The kind and quality of limestone mined and used by petitioner in making lime is used also as a fluxing agent in the production of steel. During the taxable years in issue (1956-1959, and 1961), petitioner extracted between 387,794 and 569,914 net tons of limestone which were used in its lime kilns. Petitioner used the stope method of mining to extract the limestone and incurred mining costs in excess of $2.00 per ton. As an accommodation to obtain the good will of its customers, petitioner sold small amounts of limestone at $2.00 per ton (Pet. App. B, A10-A11; Pet. App. C, A35-A36).

During the period 1956-1961, National Gypsum Company and Standard Lime and Cement Company were petitioner's principal competitors in the manufacture of lime. Like petitioner, these companies were integrated miner-manufacturers. They mined the same kind and grade of limestone and incurred approximately the same costs as petitioner. National Gypsum Company sold no limestone. However, Standard Lime and Cement Company sold approximately 10,000 to 15,000 net tons of limestone per year to various steel companies at an f.o.b. quarry price of $1.75 per ton, a price based upon the competitive conditions of the market (Pet. App. B, A11-A12; Pet. App. C, A40-A44).

In addition, Whiterock Quarries and Valley View Lime Company also mined the same quality limestone as petitioner in the same area and sold it on the market, largely to steel companies in Pittsburgh, at f.o.b. quarry prices ranging from $1.55 to $1.74 per ton. Neither sold limestone to

the integrated miner-manufacturers in the area. From 1956 through 1961, Whiterock Quarries and Valley View Lime Company mined and sold 169,519 and 345,589 tons of limestone, respectively, or 7.3 percent of the total net tonnage of limestone produced by the three integrated miner-manufacturers (including petitioner) and 25.7 percent of the limestone produced by petitioner (Pet. App. B, A12; Pet. App. C, A44-A47).

Petitioner's operations were at Bellefonte, Pennsylvania, which is located in the center of a high-calcium limestone producing area stretching through Virginia, West Virginia, and Pennsylvania. At least five producers of limestone of like kind and grade to that of petitioner's sold vast quantities of limestone to steel producing and lime-making companies in Pittsburgh, Johnstown, and Bethelehem, Pennsylvania. This is the same market in which Whiterock Quarries and Valley View Lime Company competed. These sales, f.o.b. mine or quarry, ranged from $1.46 to $1.74 per net ton. No sales were found at or above $2.00 per ton (Pet. App. B, A12-A13; Pet. App. C, A48-A57).

In computing its percentage depletion deduction for the years in issue, petitioner used the so-called "proportionate profits" method. That method derives the gross income from mining by dividing the total gross sales by the proportion that mining costs bear to total costs. However, on audit, the Commissioner of Internal Revenue determined that petitioner was not entitled to use the proportionate profits method because there existed a representative market or field price of about $1.70 per net ton f.o.b. quarry for petitioner's limestone (Pet. App. C, A61).

In this income tax refund suit brought by petitioner in the United States District Court for the Eastern District of Pennsylvania, the district court upheld petitioner's contention that there was no representative market or field price upon which to base a depletion allowance because:

(1) the relevant market area was limited to Bellefonte, Pennsylvania, where petitioner had its mine and plant, and there were only insignificant sales of limestone within that area during the taxable years, and (2) petitioner could not have sold its limestone at a profit. Accordingly, the district court held that petitioner was entitled to use the proportionate profits method (Pet. App. C, A60-A74).

The court of appeals reversed. It concluded that: (1) the criteria applied by the district court in determining a representative market or field price were contrary to *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, as well as the decisions of other courts; (2) in the relevant market, which included the greater Pittsburgh area, competitive sales of limestone at a maximum of $1.75 per net ton established a representative market or field price for petitioner's limestone; and (3) it was immaterial that, when the representative price was employed in computing petitioner's constructive mining income, petitioner could not show a profit on which to base a depletion allowance because of its high mining costs of $2.00 per net ton (Pet. App. B, A6-A24).

ARGUMENT

1. Section 611(a) of the Internal Revenue Code of 1954 permits a reasonable allowance for depletion in the case of mines and other natural deposits. Section 613 sets forth the percentage method of depletion. For the years in question, the allowance for limestone was 15 percent of the "gross income from the property" less royalties paid by the taxpayer. However, the depletion allowance cannot exceed 50 percent of the net taxable income from the property. In the case of hard minerals, "gross income from the property" is defined in Section 613(c)(1) as "gross income from mining."

If a miner simply sells his raw mineral, without applying any non-mining process, his gross income from mining is his actual gross sales. However, because a portion of the gross income of an integrated miner-manufacturer, such

as petitioner, includes income from sources other than mining, the depletion base of such an integrated miner-manufacturer is not its gross sales but the amount of income which is computed to be from the mining of the raw mineral. This was settled by *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, where this Court held that an integrated miner-manufacturer's gross income from mining should be computed at the point where a non-integrated miner would be ready to ship and sell the raw mineral. In so holding, the Court emphasized that there should be no discrimination between integrated producers and non-integrated miners; that depletion is an allowance "for exhaustion of mineral assets alone" which cannot be extended for the benefit of "manufacturers or the high-cost mine operator" (*id.* at 86, 88).

The computation of an integrated miner-manufacturer's gross income from mining is governed by Treasury Regulations, Section 1.613-4(c) *et seq.*. The preferred measure is set forth in Section 1.613-4(c)(1), which provides that the computation shall be based upon the representative market or field price "of an ore or mineral * * *." However, if a representative market or field price cannot be ascertained, then the proportionate profits method may be employed. See Section 1.613-4(d). Under that method, an integrated miner-manufacturer's constructive gross income from mining is derived from the actual gross sales of the manufactured product by allocating such gross sales between mining and non-mining operations in the proportion which mining costs bear to the total costs of the manufactured product. See *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 472 (C.A. 3).

In determining a representative market or field price, Section 1.613-4(c) of the Regulations provides that the objective is to "ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if * * * the tax-

payer had sold [them] * * *." In this case, the court of appeals' opinion amply demonstrates that there was a relevant market—the steel industry in the greater Pittsburgh area—in which the evidence established a representative market or field price of less than $1.74 per net ton f.o.b. mine for petitioner's kind and grade of limestone. Petitioner's mining costs exceeded this representative market or field price so that it had no taxable income from mining. Since Section 613(a) limits the depletion allowance to 50 percent of the net taxable income from the property, petitioner was not entitled to any depletion allowance under Section 613(a).

2. In challenging the decision of the court of appeals that there was a representative market or field price for its limestone, petitioner asserts (Pet. 10-15) a conflict with *United States* v. *Cannelton Sewer Pipe Co., supra.* Invoking the statement in *Cannelton* that "the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned" (364 U.S. at 87), petitioner argues (Pet. 14) that the presumption must be that its mine was operating at a profit since it was operating at an overall profit each year. More particularly, petitioner contends (Pet. 13) that the area within which freight costs do not become an altering factor must be taken into account because integrated miner-manufacturers have a "fortuitous advantage in having a geographically close consumption market * * *."

The decision below is entirely consistent with *Cannelton.* There, this Court considered sales of raw fire clay and shale mined by an integrated miner-manufacturer as much as 140 miles from the taxpayer's mine and manufacturing plant as within the relevant market area even though the record showed: (1) that because of high freight costs it would not have been economically feasible for the taxpayer to have purchased clay that far from its manufacturing plant (364 U.S. at 80, 86); and (2) that the taxpayer's mining costs were higher than the amount

it could have received for the raw clay on the open market (364 U.S. at 86-88). Thus, in determining a representative market price, the Court did not consider itself bound to a narrow geographic area simply because the taxpayer would not have incurred high freight costs or because its mining operation would not yield a profit.

Similarly, in this case, the record shows that the relevant market, in which petitioner could have sold its limestone and in which its potential competitors sold their limestone, was the greater Pittsburgh area. Thus, the court of appeals properly derived a representative price from significant sales in that area. The fact that petitioner's mining costs were so high that it could not sell its limestone at the representative price without incurring a loss did not make the representative price any less applicable to petitioner than it would be to a miner-manufacturer who could realize a gain by selling comparable limestone in the same market.

Moreover, in limiting the market to the location of the integrated miner-manufacturer's manufacturing plant, petitioner seeks to place the integrated miner-manufacturer in a better position than his non-integrated counterpart by making the integrated miner-manufacturer's gross income from mining turn on the profitability of the finished product. This difference in treatment is precisely contrary to *Cannelton*.

3. Petitioner further argues (Pet. 15-19) that the decision below conflicts with *United States* v. *Henderson Clay Products*, 324 F.2d 7 (C.A. 5). That case, however, is factually distinguishable. There, the taxpayer, a Texas integrated miner-manufacturer of clay into bricks, sold its finished product for less than the price of raw clay in Kentucky and Tennessee, and unsuccessfully attempted to compute its percentage depletion allowance on the amount that raw clay sold for in Kentucky and Tennessee. The Fifth Circuit determined that the price for clay in Kentucky and Tennessee could hardly be representative,

since otherwise taxpayer would have sold his clay in that market and not have incurred the expense of manufacturing bricks.

In this case, the record not only shows that there were sales of Bellefonte limestone in Pittsburgh but also that there were many sales in Pittsburgh of the same quality of limestone as petitioner's from other locations of equal or greater distance from Pittsburgh than Bellefonte. The representative price for the entire area was therefore fully applicable to a miner which operated in the area, such as petitioner. There were no comparable sales of Texas clay in Kentucky and Tennessee or vice versa in *Henderson Clay Products*.

4. Finally, petitioner contends (Pet. 19-21) that the decision below conflicts with *Kaiser Steel Corp.* v. *United States*, 411 F.2d 335 (C.A. 9). There, the taxpayer, an integrated miner-manufacturer and major consumer of iron ore in California, purchased iron ore from a non-integrated miner in Utah, which was the only non-integrated miner in the area. The price paid for the Utah ore was held to be the representative market price. Since that price was an f.o.b. mine price, and since there were no sales from the locality in California where the taxpayer mined its ore, the court adjusted the price upward because of lower freight costs from the California mine to the consumption area. The fact that the Kaiser manufacturing plant was located in the principal consumption area was purely coincidental.

Whatever the merits of the *Kaiser* decision, it is inapplicable here because the representative market price for Bellefonte limestone was the price paid in Pittsburgh. This is the market in which petitioner could have sold its limestone, if it had so desired. Since there was little disparity in freight rates from Bellefonte and other producing areas of equal distance to Pittsburgh (Pet. App. B, A24, n. 17) and since there was an f.o.b. Bellefonte mine price in the Pittsburgh market, there could be no upward adjustment

to the f.o.b. mine price for petitioner's limestone under the *Kaiser* rationale. Moreover, there is no evidence in the record that anyone would have paid more for Bellefonte limestone in Bellefonte than the f.o.b. mine price set in the market where petitioner could have sold its limestone.[1]

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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[1]The court of appeals correctly held inapplicable Section 1.613-4 (e)(2) of the Treasury Regulations (Pet. App. B, A24, n. 17), which was applied in *Kaiser* and upon which petitioner relies (Pet. 20, n. 13), because there was already an established f.o.b. mine price for Bellefonte limestone.

CERTIORARI DENIED